

Policy Briefs

IN INTERNATIONAL ECONOMICS

INSTITUTE FOR
INTERNATIONAL
ECONOMICS

NUMBER PB06-6

OCTOBER 2006

China: Toward a Consumption-Driven Growth Path

Nicholas R. Lardy

Nicholas R. Lardy, senior fellow since 2003, was a senior fellow in the Foreign Policy Studies Program at the Brookings Institution from 1995 to 2003. He was the director of the Henry M. Jackson School of International Studies at the University of Washington from 1991 to 1995. From 1997 through the spring of 2000, he was the Frederick Frank Adjunct Professor of International Trade and Finance at the Yale University School of Management. His publications include *China: The Balance Sheet* (PublicAffairs, 2006), *Integrating China into the Global Economy* (Brookings Institution Press, 2002), *China's Unfinished Economic Revolution* (Brookings Institution Press, 1998), *China in the World Economy* (Institute for International Economics, 1994), *Foreign Trade and Economic Reform in China, 1978–1990* (Cambridge University Press, 1992), and *Agriculture in China's Modern Economic Development* (Cambridge University Press, 1983).

© Institute for International Economics. All rights reserved.

In December 2004 China's top political leadership agreed to fundamentally alter the country's growth strategy. In place of investment and export-led development, they endorsed transitioning to a growth path that relied more on expanding domestic consumption.¹ Since 2004, China's top leadership, most notably Premier Wen Jiabao in his speech to the National People's Congress in the spring of 2006, has reiterated the goal of strengthening domestic consumption as a major source of economic growth.² This policy brief examines the reasons underlying

ing the leadership decision, the implications of this transition for the United States and the global economy, and the steps that have been taken to embark on the new growth path.

China's announced decision to transition away from growth driven by investment and a growing global trade surplus toward one more dependent on consumption is laudable. It increases the likelihood of China's sustaining its strong growth of recent years, achieving more rapid job creation, improving income distribution or at least slowing the pace of rising income inequality, and reducing its outsized increases in energy consumption of recent years. It also would contribute to a reduction of global economic imbalances.

But to date China's policy initiatives have been too modest to change its underlying growth dynamic. As a result China's external surplus continues to balloon and, short of a US recession, seems likely to expand further in 2007 as well. China also is falling short of meeting several of its key domestic economic objectives.

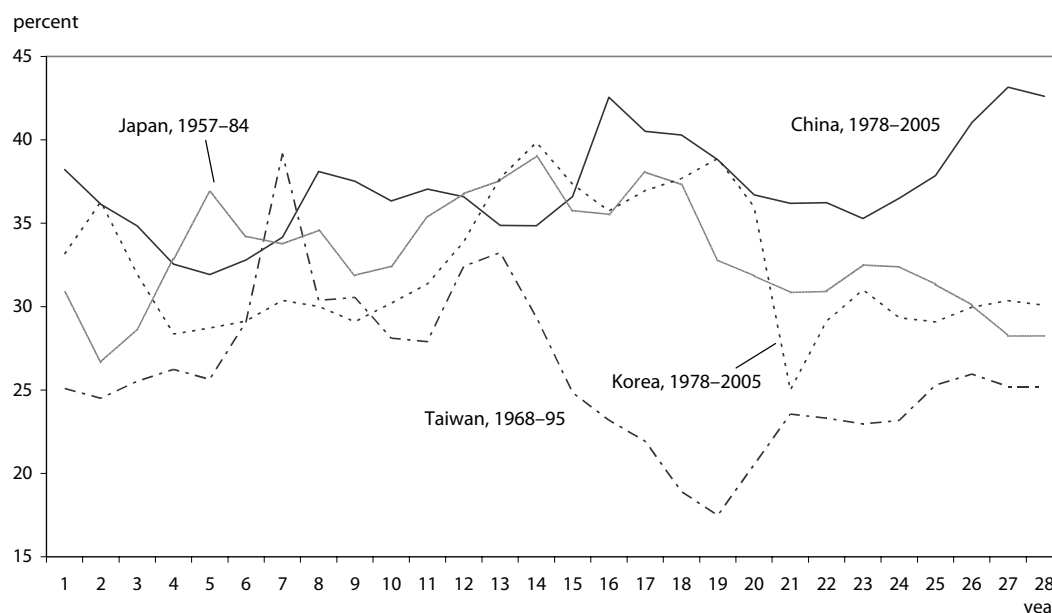
SOURCES OF CHINA'S ECONOMIC GROWTH

China has been the fastest growing economy in the world over almost three decades, expanding at 10 percent a year in real terms. As a result, real GDP in 2005 was about 12 times the level of 1978, when Deng Xiaoping launched China on the path of economic reform (National Bureau of Statistics of China 2006a, 24). China is now the world's fourth largest economy and its third largest trader and highly likely, within a year, to move up a notch in each category. Given this stunning long-term success, why would China's leadership even entertain the idea of shifting to a new growth paradigm?

In all economies the expansion of output is the sum of the growth of consumption plus investment plus net exports of goods and services. Expanding investment has been a major and increasingly important driver of China's growth. As shown in figure 1, in the first decade or so of economic reform, investment averaged 36 percent of GDP, relatively high by the standard of developing countries generally but not in comparison with China's East Asian neighbors when their investment shares were at their highest. But since the beginning of the 1990s China's investment rate has trended up. In 1993 and again in both 2004 and 2005 investment as a share of GDP exceeded 42 percent, a level well above

1. "Central Economic Work Conference Convened in Beijing December 3 to 5," *People's Daily*, December 6, 2004, 1, www.people.com.cn (accessed July 21, 2006).

2. Wen Jiabao, "Report on the Work of the Government," *People's Daily*, March 14, 2006, <http://english.people.com.cn> (accessed March 14, 2006).

Figure 1 Capital formation as percent of GDP

Note: For each country the time period is when the average rate of capital formation was the highest.

Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2006*; Council for Economic Planning and Development of Republic of China, *Taiwan Statistical Data Book*, 1997 and 2006; International Monetary Fund, *International Financial Statistics*, <http://ifs.apdi.net/> (accessed September 27, 2006).

the historic experience of China's East Asian neighbors in their high growth periods.³ Rising investment has been fueled by a rise in the national saving rate, which reached an unprecedented 50 percent of GDP in 2005.⁴

Consumption growth has been rapid in absolute terms throughout the reform period, but over the last decade or so its relative importance as a source of economic growth has diminished substantially compared with that of investment. In the 1980s household consumption averaged slightly more than half of GDP. This share fell to an average of 46 percent in the 1990s. But after 2000 household consumption as a share of GDP fell sharply and by 2005 accounted for only 38 percent of GDP, the lowest share of any major economy in the world.⁵ In the United

States, household consumption accounted for 70 percent of GDP in the same year. In the United Kingdom, the consumption share was 60 percent. In India it was 61 percent.

As a result of this changing structure of demand, in 2001–05, increases in capital investment accounted for a little over half of China's economic growth, an unusually high share by international standards (National Bureau of Statistics of China 2006b, 70).

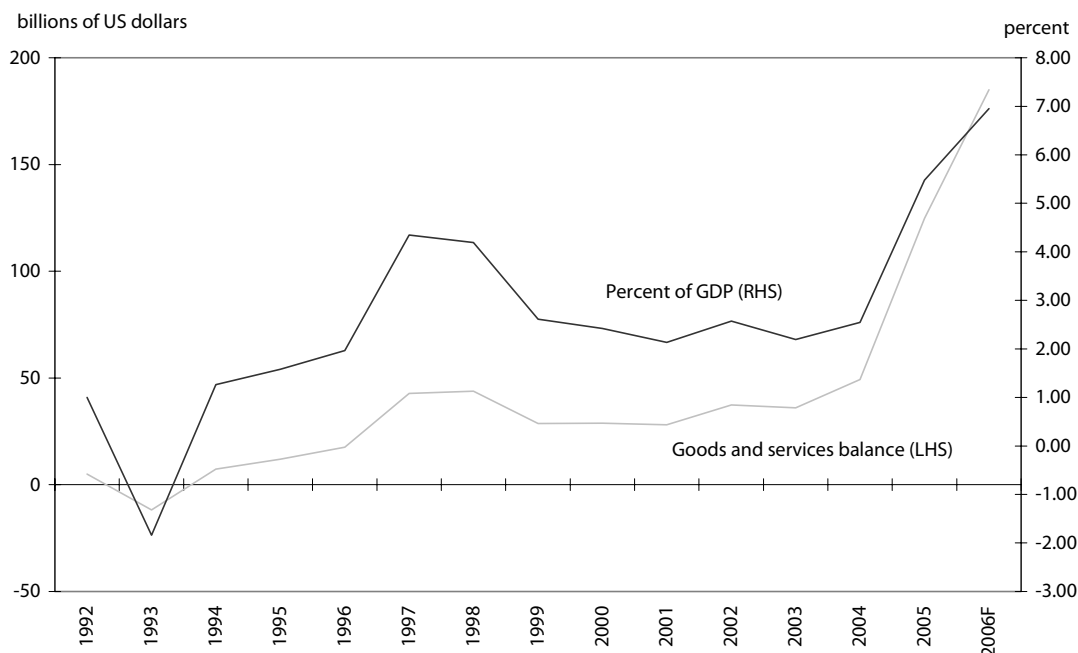
In the last few years, the growth of net exports of goods and services has also become, for the first time in almost a decade, a major source of economic growth. Net exports of goods alone, as reported by China's Ministry of Commerce, tripled from \$32 billion or 1.7 percent of GDP in 2004 to more than \$100 billion or 4.6 percent of GDP in 2005 (National Bureau of Statistics of China 2006a, 169).⁶ As shown in figure 2, the net exports of goods and services in 2005 reflected in China's GDP expenditure accounts more than doubled to reach \$125 billion and accounted for one-quarter of the growth of the economy. In 2006 I estimate net exports of goods and services will reach

3. All of the analysis of the expenditure components of GDP, i.e., consumption, investment, and net exports, is based on the revised GDP expenditure data for 1978 through 2005 released by the National Bureau of Statistics of China (2006b) in late September 2006.

4. By definition, the national saving rate is equal to investment as a share of GDP plus the current account as a percent of GDP. In China, these were 42.6 and 7.0 percent of GDP, respectively, in 2005.

5. The declining share of consumption is due to both a decline in household disposable income as a share of GDP and a decline in consumption as a share of disposable income.

6. The ministry's data, which are released monthly, cover goods only and measure imports inclusive of transportation and insurance charges. Thus the ministry's annual import number differs from the data on trade in goods reported in China's balance of payments in which imports, in accordance with standard conventions, are measured on a free on board (f.o.b.) basis.

Figure 2 Net exports of goods and services, 1992–2006F

Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2006*; International Monetary Fund, *International Financial Statistics*; author's calculations.

\$185 billion, and the increase in net exports of goods and services will account for a fifth of China's growth. The contribution of net exports to China's growth has rarely been as high as in 2005–06.

RETHINKING CHINA'S GROWTH STRATEGY

The decision of China's leadership at its critical annual Central Economic Work Conference in December 2004 reflected the judgment that China's growth path was not sustainable in the long run. This does not mean the leadership seeks to slow the rate of economic growth markedly. Rather they wish primarily to change the structure of demand and to raise the efficiency of investment. In short, they believe that rapid growth is more likely to prove sustainable if it is generated more by expanding consumption by Chinese households and less by surging investment by Chinese companies and a ballooning global trade surplus.

While the Chinese Communist Party is hardly a transparent decision-making body, it appears that several factors underlay its December 2004 policy choice. First, there was growing evidence that investment-driven growth, or what is sometimes called an extensive pattern of growth, was leading to less efficiency in the use of resources. By most metrics, as investment growth has accelerated, the efficiency of resource use has de-

clined. Multifactor productivity growth, a critical contributor to economic expansion in all economies, averaged almost 4 percent per annum in the first 15 years of economic reform (1978–93). While still high by international standards, this pace slowed to only 3 percent since 1993 (Kuijs and Wang 2005, 2). In short, as the investment share of GDP rose, the contribution of productivity improvements to GDP growth fell. In the words of Martin Wolf (2005), the chief economics commentator for the *Financial Times*, the surprising thing about the Chinese economy in recent years is not, as so frequently asserted, how fast it is growing but rather, given the stupendous share of output devoted to investment, how slowly it is growing.

The slowing pace of factor productivity growth can be attributed in part to overinvestment and the emergence of excess capacity in a number of important industries. China emerged as the world's largest steel producer in 1996 when its output reached 100 million metric tons, putting it ahead of both the United States and Japan for the first time. The industry has continued to grow at a torrid pace. The National Development and Reform Commission (2006) reported that in 2005 output reached 350 million metric tons, and capacity was even larger at 470 million metric tons. Excess capacity of China's steel industry of 120 million tons exceeded the 112.5 million metric tons of steel output of the world's second largest producer, Japan. Excess capacity will expand further in 2006 since additional capacity of 70 million

tons of steel production capacity was under construction but not completed in 2005, while demand growth is softening.⁷

As a result of excess production, steel prices by year-end 2005 were down a quarter compared with a year earlier and by one-third compared with the peak levels of March.⁸ This decline in prices has dramatically transformed the profitability of the industry. When China's investment rate soared between 2000 and 2004, the demand for steel rose rapidly, and steel industry profits skyrocketed from less than RMB5 billion (\$600 million) in 1999 to RMB127 billion (\$15.7 billion) in 2005. But as

**China's announced decision to
transition away from growth driven by
investment and a growing global trade
surplus toward one more dependent
on consumption is laudable.**

excess capacity emerged, the growth of profits waned. Profits of steel firms doubled in 2003 and rose a further 80 percent in 2004 but increased by only 1 percent in 2005. In the first half of 2006, profits in the industry fell by 20 percent compared with the same period in 2005.⁹ For the year as a whole, profits are expected to fall by half, according to a Beijing securities firm. But the steel industry invested about RMB650 billion (\$80 billion) in the five years 2001–05, of which less than two-fifths (\$30 billion) was financed by after-tax profits. This year a decline of 50 percent or more in industry earnings would impair the ability of some steel firms to service their debt.

The situation is worse in the ferroalloy industry, where capacity utilization in 2005 was only 40 percent. Similar excess capacity has emerged in aluminum, autos, cement, and coke. For example, output of vehicles in 2005 was 6 million units, while capacity was 8.7 million units, with capacity for an additional 2.2 million units under construction. Coke production in 2005 was 230 million tons, but capacity exceeded that by 100 million tons, and the price of coke fell from \$450 per ton in 2004 to only \$130 per ton in 2005.¹⁰ Excess investment also

is evident in high-end property in some cities, where prices are now falling for the first time. Even in electric power, which was in acutely short supply only two years ago, excess capacity is expected to emerge by 2007, as additional capacity of 300 gigawatts now under construction or planned comes on stream.¹¹

The second reason underlying the leadership decision to abandon the extensive pattern of economic development is the recognition that it has impeded the growth of personal consumption. Personal consumption in China in 2005 was 30 percent less than the level that would have been achieved if the household consumption share of GDP had remained at the level of 1990 rather than falling by more than ten percentage points. A useful comparison is with India. In 2004 China's per capita GDP was two and a half times that of India. But because household consumption as a share of GDP was so much lower in China, per capita consumption in China exceeded that in India by only two-thirds.¹² The ultimate purpose of economic growth everywhere is improvements in human welfare. By this standard, China is falling far below potential.

Third, and closely related to the slow growth of consumption, China's extensive pattern of development has generated very modest gains in employment. Between 1978 and 1993 employment expanded by 2.5 percent per annum, but between 1993 and 2004, when the investment share of GDP was much higher than in the 1980s, employment growth slowed to only slightly over 1 percent (Kuijs and Wang 2005). The more capital-intensive pattern of growth that emerged in the 1990s appears to have contributed to a slower pace of job creation for the simple reason that the steel and other industries producing investment goods employ far fewer workers per unit of capital than do light industries producing consumer goods, not to mention the even less favorable comparison with the service sector.

Another reason China's leadership wishes to transition to a more consumption-driven growth path is burgeoning energy consumption and its detrimental effects on the environment. Investment-driven growth has required the output of machinery and equipment, and the inputs to produce them, to grow much more rapidly than the output of consumer goods. Rapid growth of output of investment goods, in turn, increases the demand for energy disproportionately. China's energy elasticity of GDP growth (the number of units of energy required to produce an additional unit of output) averaged a very modest 0.6 in the 1980s and 1990s, leading to a substantial reduc-

7. Gong Zhengzheng, "Steel Sector to Produce Slim Profits This Year," *China Daily*, March 3, 2006, 9.

8. Gong Zhengzheng, "Steel Profits Expected to Decline," *China Daily*, January 26, 2006, 9.

9. Zheng Lifei, "Soaring Industrial Profits Might Prompt Investment," *China Daily*, July 21, 2006, 9.

10. Wang Ying, "New Policies Looming for Fragmented Coke Industry," *China Daily*, February 15, 2006.

11. Liu Ping, "Overcapacity in 13 Industrial Sectors," *China Economic News*, May 29, 2006, 5–6.

12. Calculated on the basis of the Indian Ministry of Statistics and Program Implementation, *National Account Statistics*, available at <http://mospi.nic.in>; IMF, *International Financial Statistics*; and National Bureau of Statistics of China (2006a, 34, 36, 171).

tion in the amount of energy required to produce each unit of GDP. But this ratio has almost doubled in the past five years (National Bureau of Statistics of China 2006a, 147). While this dramatic increase has not yet been properly explained, it is likely that the more capital-intensive growth path has been a significant contributor.

Since two-thirds of China's energy comes from coal, the burgeoning demand for energy generated by capital-intensive growth has increased coal consumption by two-thirds since 2000. Coal consumption reached more than 2 billion tons in 2005, almost twice the coal consumption of the United

Evidence to date suggests that the transition toward consumption-driven growth is off to a slow start.

States, even though China's economy is only one-sixth the size of the United States. As a result, China is now the second largest emitter of greenhouse gas and is home to 16 of the 20 cities with the worst air pollution on the globe. As a result of the massive increase in the consumption of coal, the State Environmental Protection Agency (SEPA) reported that, rather than cutting sulfur dioxide emissions in 2000–2005 by 10 percent to 18 million tons as planned, by 2005 emissions rose to 25.5 million tons, 42 percent above the goal.¹³

A fifth factor motivating China's leadership to seek a transition to a more consumption-driven growth pattern is a bit below the radar but nonetheless quite important. Excessive reliance on investment-driven growth in recent years threatens to undo the progress China has made over the past six years in developing a commercially oriented banking system. A critical component of this process has been the injection of almost RMB4 trillion (\$500 billion) to cover past loan losses and to raise capital adequacy to meet prudential standards (Ma Guonan 2006). The vast majority of funding has come directly from the government.

Excess investment in some sectors, leading to excess capacity and falling prices, could create a new wave of nonperforming loans that would erode the substantial balance sheet improvements of state-owned banks over the past few years and could push many city commercial banks, which on average are far weaker, into insolvency. The National Development and Reform Commission (2006) in its report to the National People's Congress acknowledged, "adverse effects of surplus production capacity in some industries have begun to emerge. Prices for

the products of these industries dropped and inventories grew, corporate profits shrank and losses mounted, and potential financial risk has increased." The steel industry, just discussed, is but one example.

The absence of rising nonperforming loans in the banking system in the past few years is not necessarily a sign that all is well, since China has been in a period of accelerating growth and corporate profits have been rising, albeit at a more modest rate recently in industries like steel. Distress in the banking system is likely to emerge, however, in any slowdown in economic growth over the next few years. But excess capacity is so large in some industries that their ability to service their debt is in question, even in a continuing strong macroeconomic environment.

A final factor underlining the leadership's desire to transition to a more consumption-oriented growth path is that excess reliance on expansion of net exports, i.e., a growing trade surplus, raises the prospect of a protectionist backlash in the United States and other important markets for Chinese exports. China's central bank, the People's Bank of China, was perhaps the first to explicitly acknowledge this factor in its Report on the Implementation of Monetary Policy 2005Q2, in which it candidly stated that an excessive trade surplus "will escalate trade frictions" (People's Bank of China, Monetary Policy Analysis Small Group 2005, 28).

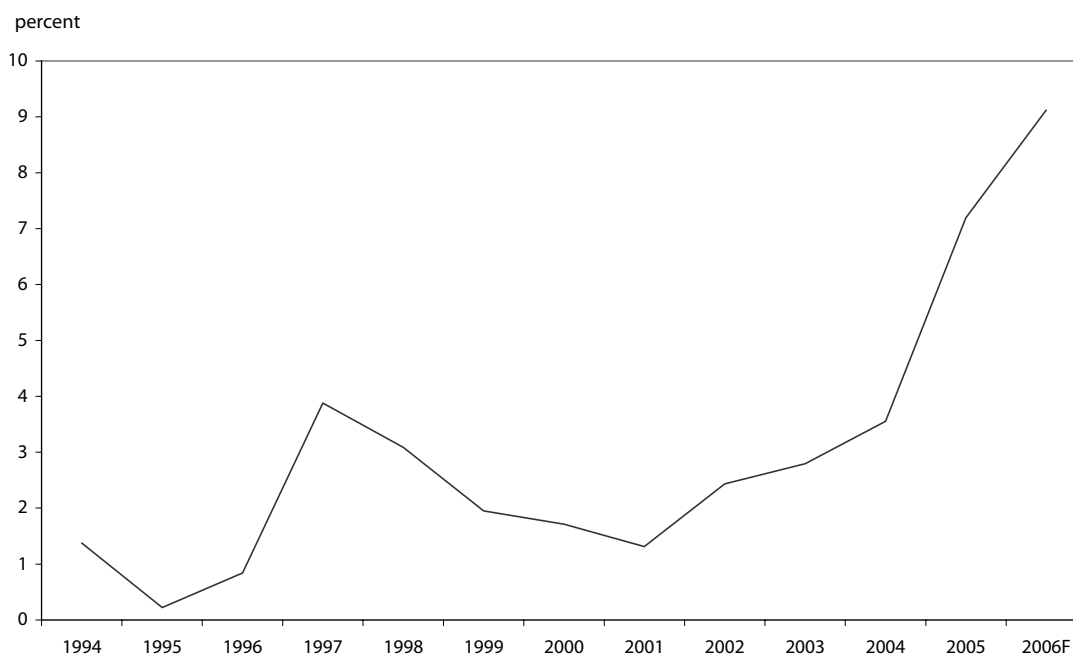
In sum, for a variety of reasons China's top political leadership and its leading economic advisory institutions by late 2004 came to the view that sustaining China's long-term rapid growth trajectory required a significant modification of the underlying growth strategy. Failing such a modification they feared that rapid growth could not be sustained.

IMPLICATIONS FOR THE GLOBAL ECONOMY

China's new growth strategy, if realized, would have positive implications not only for China, but also for the global economy. As shown in figure 3, China's current account surplus has soared in recent years. In 2006 China decisively surpassed Japan for the first time to become far and away the world's largest global current account surplus country.¹⁴ China now is a major contributor to global economic imbalances, along with the United States, which has the world's largest current account deficit. The successful transition to a pattern of growth driven more by do-

13. Shai Oster, "Pollutant Takes rising Toll in China," *Wall Street Journal*, August 4, 2006, <http://online.wsj.com> (accessed August 4, 2006).

14. In 2005 China's current account surplus was \$161 billion, slightly less than Japan's \$170 billion. Japan's surplus in the 12 months through July 2006 was \$165 billion, suggesting a surplus for the year as a whole about the same as last year's. I estimate China's 2005 current account surplus at \$240 billion, based on China's goods trade through August and estimates of the other components of the current account—trade in services, investment income, and transfers.

Figure 3 Current account balance as percent of GDP, 1994–2006F

Source: National Bureau of Statistics of China, *China Statistical Abstract 2006*; author's calculations.

mestic consumption demand entails a reduction of the national saving rate. That, in turn, would reduce China's current account surplus. This adjustment should be facilitated by an appreciation of the Chinese currency, which would mitigate inflationary pressures that would otherwise emerge from the increase in consumption demand. This will happen through two channels. First, appreciation would tend to reduce the pace of growth of exports and increase the pace of growth of imports, thus expanding domestic supply. Second, a more flexible exchange rate would allow the government greater flexibility in the use of interest rate policy (Goodfriend and Prasad 2006). As will be argued below, higher real interest rates are almost certainly necessary to reduce China's excessive rate of investment, which in turn is a prerequisite to a successful transition to a more consumption-driven growth path.

POLICIES TO PROMOTE CONSUMPTION-DRIVEN GROWTH

Promoting domestic demand as a source of economic expansion requires that the growth of household and/or government consumption increase relative to that of investment and net exports. Policies to promote consumption can be based on cutting personal income taxes or increasing government consumption expenditures (i.e., government noninvestment

outlays). Shifting to a more consumption-driven growth path in China also will require significant changes in its exchange rate policy. Under current conditions a more flexible exchange rate regime would certainly lead to appreciation of the renminbi, simultaneously tending to reduce net exports and, as will be explained below, increasing the flexibility of the government to raise interest rates. The latter is a prerequisite for slowing the rapid pace of investment spending of recent years. Changes in corporate tax policy, discussed below, also offer an opportunity to contribute to rebalancing the sources of economic growth in China.

In many economies, governments can increase personal consumption through fiscal stimulus in the form of tax cuts on household income. But, as will be discussed, this avenue is of limited relevance in China, where direct taxes on households are relatively small to start with and the government's cuts have been timid.

The alternative form of fiscal expansion is expenditure-based. If tax cuts cannot increase private consumption significantly, the government can increase its budgetary expenditures to add to domestic demand. Given already high levels of investment and the emergence of excess capacity in many industries, however, the government needs to increase its non-investment outlays, notably those on health, education, welfare, and pensions. There is enormous scope to do so, since

governments at all levels combined in China spend only about 3.5 percent of GDP on these programs (National Bureau of Statistics of China 2005, 278).¹⁵

The government has considerable scope to increase its own consumption expenditures without raising taxes on households, which likely would depress household consumption, offsetting to some degree the increase in government consumption. The government could simply reduce its own investment expenditures and reallocate the funds to consumption.¹⁶ The government itself directly undertakes about 5 percent of all investment (National Bureau of Statistics of China 2006a, 52). In addition, the government budget allocates substantial additional funds, called “capital transfers,” that are used to finance investment expenditures.¹⁷ For 2003, the most recent year for which data have been released, these capital transfers were the equivalent of 10 percent of all fixed investment.¹⁸ There is no evidence that capital transfers have been reduced in recent years, so the government’s direct and indirect investment outlays combined probably amount to about 7 to 8 percent of GDP. A reduction in the government’s direct investment and cutting capital transfers would free up resources to increase government consumption—i.e., outlays for health, education, welfare, and pensions. That would contribute significantly to a rebalancing of the structure of demand, away from investment and toward consumption.

An increase in household consumption as a share of GDP also could contribute significantly to the transition to a more domestic consumption-driven growth path. That, in turn, requires a reduction in the saving rate of households, which has increased significantly since the 1980s and has been running at about 25 percent of disposable income since 2000 (Kuijs 2006). By contrast, in the United States in 2005 households spent more than their disposable income, i.e., the saving rate was slightly negative!

Any analysis of the likelihood of a reduction in the saving rate of households must begin by analyzing the motives for household saving. One motivation is clearly precautionary—to cope with life’s uncertainties such as illness, unemployment, or injury. Increasingly, as the government and enterprises have reduced the support they provide, this expenditure has become an individual responsibility. In urban areas only about half the

population, for example, is covered by basic health insurance (OECD 2005, 185), and in rural areas less than a fifth of the population is covered by a cooperative health insurance program initiated on a trial basis in 2002. As the share of health expenditures paid directly by the government or borne by enterprises has waned, the share of total health outlays borne by individuals on an out-of-pocket basis increased from around 20 percent in 1978 to more than 55 percent by 2003 (IMF 2006, 49; National Bureau of Statistics of China 2005, 770). As a consequence, many households save to cover potential future medical expenses. Indeed, the reduction in the share of health expenditures provided through the government and by employers is likely a key reason that household saving as a share of disposable income increased significantly in the 1990s.

The share of China’s workforce in 2005 covered by unemployment insurance is only 14 percent, and those covered by

China’s external surplus continues to balloon and, short of a US recession, seems likely to expand further in 2007 as well.

workers’ compensation is even lower at only 11 percent (National Bureau of Statistics of China 2006a, 43, 201). Thus the vast majority of workers have to save rather than rely on insurance to compensate for potential income interruption due to job loss or injury, adding further to the incentive for precautionary savings.

Another significant motivation for households to save is for retirement and for the education of their children. This is particularly true in China because the basic government pension scheme is extremely limited and government expenditures on education are modest. In 2005 the pension scheme covered 131.2 million workers, only 17 percent of those employed, plus 43.7 million retirees (National Bureau of Statistics of China 2006a, 43, 201). Moreover, a worker must contribute for a minimum of 15 years before he or she is entitled to draw any benefits at retirement. And the basic pension scheme is designed to provide a pension equal to only 20 percent of average local wages, independent of a worker’s lifetime earnings.¹⁹

Although the authorities in China over the past decade have repeatedly asserted the goal of improving the social safety net, pension system coverage is expanding extremely slowly. Between 2000 and 2005 the share of those employed participating

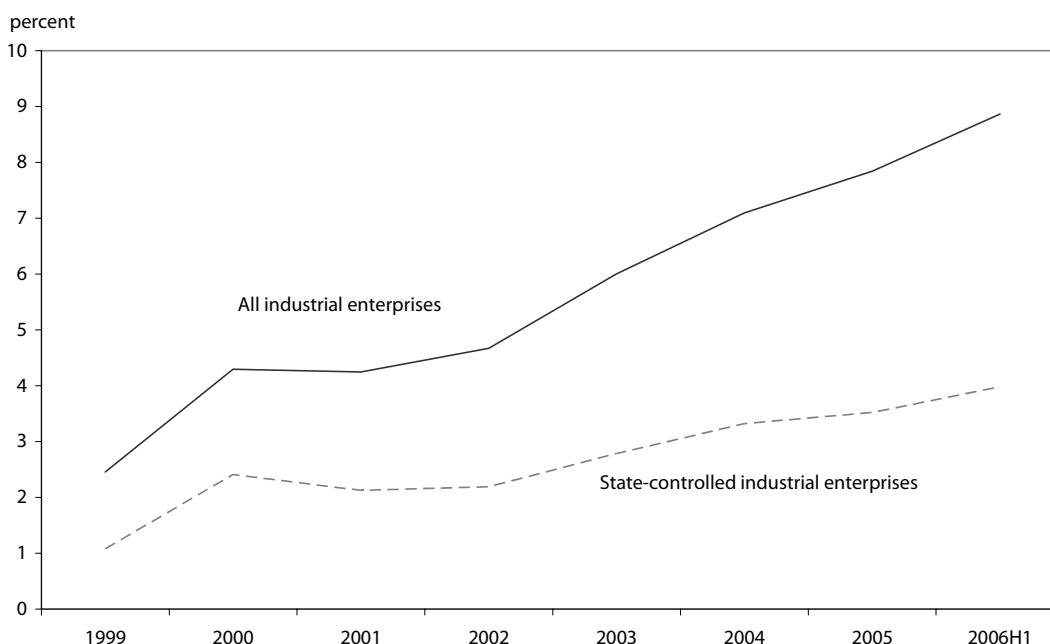
15. Excluding capital expenditures.

16. This reallocation, of course, would reduce government savings since the latter are defined as current revenues less current (i.e., noninvestment) outlays.

17. Kuijs (2006, 7) believes these funds are transferred to enterprises in electric power, water, transport, and other infrastructure sectors.

18. See “Flow of Funds Table (Physical Transactions, 2003),” in National Bureau of Statistics of China (2006b, 88–89).

19. The basic pension scheme, the only one to which enterprises contribute, is the first of a three-pillar retirement program. There are, in addition, mandatory and optional individual contributory pillars. The basic scheme and the mandatory individual schemes combined are designed to replace about 50 percent of pre-retirement income.

Figure 4 Industry profits as percent of GDP, 1999–2006H1

Sources: National Bureau of Statistics of China, *China Statistical Yearbook 2005*; People's Bank of China, Monetary Policy Analysis Small Group (2006).

in the program rose by only 2.8 percentage points (National Bureau of Statistics of China 2006a, 43, 201; 2005, 117). At that pace universal pension coverage will not be achieved until 2155—150 years from now!

Finally, households also save to finance education expenditures. Families are responsible for a significant share of national expenditures on education, since government expenditures on education amount to only 2 percent of GDP. In 2004 per capita expenditures on education of urban households amounted to RMB560 or 8 percent of total consumption expenditures (National Bureau of Statistics of China 2005, 352). Primary school fees are a large financial burden, particularly for poorer rural households.

In the long run, of course, increased provision of health care, unemployment compensation, and workers' compensation through the government budget can be expected to reduce precautionary saving on the part of households. As families gain confidence that the government will provide more of these services, they will reduce their own saving voluntarily, i.e., increase consumption as a share of their own disposable income. Similarly greater government provision of educational services and old age support could lead to a reduction in savings associated with lifecycle events, such as children's education and retirement.

In other countries, increased government provision of health services has led directly to an increase in household con-

sumption (China Economic Research and Advisory Programme 2005). For example, the introduction of National Health Insurance in Taiwan, which raised the fraction of the insured population from 57 percent in 1994 to 97 percent in 1998, substantially reduced household uncertainty about future health expenditures and thus stimulated increased consumption outlays. Households that previously enjoyed no health insurance coverage increased their consumption expenditures by an average of over 4 percent (Chou, Liu, and Hammitt 2002, 1889).²⁰ Thus, China's transition to a more consumption-driven growth path will probably need to start with increased government consumption expenditures but with time is likely to be reinforced by changes in household consumption and saving decisions.

For China, exchange rate policy is an important third element potentially supporting the transition to a more consumption-driven growth path. The reason is that China's de facto fixed exchange rate system is a critical factor limiting the independence of monetary policy. Although China's central bank has had some success in sterilizing large foreign capital inflows, it has generally been reluctant to raise domestic interest rates for fear that these inflows could become unmanageably large. Fixed

20. Consumption increased by 2.6 percent in households where one spouse was not in the labor force or unemployed and by 5.7 percent in households where both spouses worked.

nominal domestic interest rates on loans in 2002–03, when domestic price inflation was rising, led to a sharp decline in and ultimately to negative real interest rates on loans. Between the first half of 2002 through the third quarter of 2004, the real interest rate on loans fell by 13 percentage points, from almost 9 to –4 percent.²¹ That fueled a very large increase in the demand for bank loans and thus a sharp increase in capital formation.

A more flexible exchange rate policy would allow the central bank greater flexibility in setting domestic interest rates and thus increase the potential to mitigate macroeconomic cycles by raising lending rates to moderate investment booms. That will

**Despite much lip service to increasing
the provision of social services
financed through the budget,
there is little evidence that a
fundamental shift in government
spending priorities is under way.**

lead, on average, to a lower rate of investment. A reduction in the rate of investment is a critical component of the policies to transition to a more consumption-driven growth path. In the absence of a reduction in investment, increased consumption demand would lead to inflation.

Finally, corporate tax policy should contribute importantly to the rebalancing of the sources of economic growth in China. As shown in figure 4, from 1998 through the first half of 2006 profits of industrial enterprises in China soared from less than 2 percent to almost 9 percent of GDP (National Bureau of Statistics of China 2005, 494; People's Bank of China, Monetary Policy Analysis Small Group 2006, 33). Although these profits are subject to a 33 percent corporate income tax, retained after-tax earnings of industrial firms in the first half of 2006 amounted to 5.8 percent of GDP compared with an estimated 1.6 percent in 1998.²² In addition, industrial firms retain depreciation funds that amount to another 6 to 7 percent of GDP (Kuijs, Mako, and Zhang 2005).

21. The real interest rate is calculated as the one-year lending rate minus the inflation rate reflected in the corporate goods price index. The latter index is compiled and published by the People's Bank of China.

22. Industrial sector pretax profits were RMB810 billion in the first half of 2006 (People's Bank of China, Monetary Policy Analysis Small Group 2006, 33). These profits are subject to the corporate income tax of 33 percent. In addition, China's three largest oil producers are also subject to a windfall profits tax, which amounted to RMB16.19 billion in the first half of 2006. Thus after-tax profits can be estimated at RMB530 billion or 5.8 percent of reported first half GDP of RMB9,144 billion.

Unfortunately, in state-owned firms these funds are not subject to a significant rate of return test prior to being reinvested. The reason is that the only available alternative to reinvestment is low-yielding bank deposits. Taking into account the relevant measure of inflation, the real after-tax rate of return on corporate deposits is typically negative.²³ Given a negative real rate of return on deposits, from the point of view of a manager of a state enterprise, it is rational to reinvest retained profits and depreciation funds even when they have slightly negative anticipated rates of return.

Given the upward trend in profits as a share of GDP and apparent upward trend in depreciation funds as a share of GDP as well, retained earnings have become an increasingly important source of investment financing in China's corporate sector and have contributed to the rising investment share of GDP in recent years.

For a number of years, the authorities have been discussing requiring state-owned enterprises to pay dividends to their owner—the government (Kuijs, Mako, and Zhang 2005). This policy has the potential simultaneously to reduce the pace at which investment grows, or at least subject investment to a more demanding rate of return hurdle, and to provide the government with additional resources that could be used to enhance government-provided social services. In September 2006 Li Rongrong, chairman of China's State-Owned Asset Supervision and Administration Commission, announced that the government would begin collecting such dividends in 2007.²⁴ While the magnitude of required payments has not been announced, if state-owned companies were to pay half their after-tax income as dividends, this would have amounted to 1.3 percent of GDP in the first half of 2006.²⁵ The government could gain additional, larger amounts by reducing the depreciation rates used by firms in calculating their taxable income.

23. For example, starting August 15, 2006, the People's Bank of China raised the nominal interest rate on a one-year term corporate deposit to 2.52 percent. The corporate goods price index in August 2006 was up 2.9 percent compared with August 2005, making the real return –0.38 percent. Nominal returns on short-term deposits are less than 2.52 percent, as low as 0.72 percent for demand deposits, making the real return on deposits of less than one year as low as –2.18 percent.

24. Rick Carew, "China Expects to Collect Dividends by Next Year," *Wall Street Journal*, September 18, 2006, <http://online.wsj.com> (accessed September 18, 2006).

25. Profits of the industrial sector in the first half were RMB810 billion. I assume the share accruing to state-owned and state-controlled firms was 45 percent of the total, the share they accounted for in 2004 (National Bureau of Statistics of China 2005, 494 and 497). Deducting the windfall profits tax of state-owned oil companies and the corporate income tax results in an estimate of after-tax profits of RMB233.4 billion or 2.6 percent of GDP.

THE TRAJECTORY THUS FAR

How aggressively is China adopting policies that could lead to a growth path that is more consumption-driven and less dependent on burgeoning investment and an expanding global trade surplus?

Even in advance of the 2004 Central Economic Work Conference, which formally endorsed the transition to a more domestic consumption-driven growth path, the government initiated a program to raise farm incomes by reducing the agricultural tax, long levied on farm income (Ministry of Finance, Ministry of Agriculture, and State Tax Bureau). In 2004 the tax, which was set at 8.4 percent of average yields, was eliminated in two provinces and reduced by three percentage points in 11 provinces and by one percentage point in all other

There is little evidence of a more flexible exchange rate and increased independence of monetary policy that would allow higher interest rates.

provinces.²⁶ By the end of 2005 the government had eliminated the tax in 28 provincial-level administrative units and had reduced it to less than 2 percent in the remaining three provinces, where the tax will be eliminated entirely in 2006 (State Tax Bureau 2005b).

The early initiative to eliminate the agricultural tax was followed in 2006 with a doubling to RMB1,600, of the monthly income exempt from the personal income tax levied on wage earners, who live almost exclusively in urban areas. The central government has encouraged local governments to raise the minimum wage in urban areas, potentially increasing the consumption of low-income workers.

All of these initiatives, however, are quite modest. Agricultural taxes collected fell from RMB33.7 billion in 2003 to RMB19.79 billion in 2004 and then to only RMB1.279 billion in 2005 (National Bureau of Statistics of China 2005, 281; 2006a, 75). The tax burden on farmers was reduced by RMB23.4 billion in 2004 and an additional RMB22 billion in 2005 (Ministry of Finance 2005; State Tax Bureau 2005b). However, RMB23.4 billion is the equivalent of only 1 percent of rural consumption expenditure or 0.1 percent of GDP in 2004. More importantly, the cut in the agricultural tax was off-

set by record increases in other taxes levied on rural residents. In 2004 proceeds from the tax on occupied, cultivated land and the tax levied on contracts used to transfer land use rights or the sale, exchange, and inheritance of houses increased by one-half or RMB21 billion. The same taxes rose by an additional one-third or RMB22 billion in 2005. These increases entirely offset the reductions in the agricultural tax (National Bureau of Statistics of China 2005, 281; 2006a, 75).

Similarly, reductions in the personal income tax are not a very potent policy instrument. The proceeds of the personal income tax in 2005 amounted to RMB210 billion, only 1.1 percent of GDP (National Bureau of Statistics of China 2006a, 20, 66). By comparison, the personal income tax in the United States prior to the major income tax cut under President George W. Bush in 2001 represented almost 10 percent of GDP. Tax cuts reduced this share to about 7 percent, translating into an increase in household disposable income of over 4 percent. China starts with an income tax one-tenth the relative size of that in the United States, and doubling the income tax exemption is a modest tax cut. The State Tax Bureau (2005a) reports that raising the exemption will reduce the personal income tax take by RMB28 billion in 2006. But this is an estimated 0.13 percent of GDP,²⁷ a tiny amount compared with the Bush tax cuts, which reduced personal income taxes by 3 percentage points of GDP.

Finally, it is quite unlikely that the increase in minimum wages that went into effect on July 1, 2006, in most administrative jurisdictions will have a significant positive effect on household consumption expenditures. There are two reasons for this. First, the *Regulations on the Minimum Wage* of the Chinese Ministry of Labor and Social Security (2003) give local governments considerable leeway in setting the minimum wage. In practice, in most jurisdictions, the minimum wage is only about one-fifth to one-quarter the average wage prevailing locally.²⁸ Second, the share of the workforce earning the minimum wage appears to be quite small. In Beijing, for example, in 2002 minimum wage workers accounted for only 2.4 percent of the workforce.²⁹ Given the low ratio of the minimum wage to the average wage and the small share of the workforce earning the minimum wage, the 6.5 percent

26. In 2004 the tax was eliminated in Jilin and Heilongjiang provinces, cut by 3 percentage points in 11 other grain-growing provinces (Hebei, Inner Mongolia, Liaoning, Jiangsu, Anhui, Jiangxi, Shandong, Henan, Hubei, Hunan, and Sichuan), and reduced by 1 percentage point in all other provinces.

27. Assuming nominal GDP growth of 14 percent in 2006, based on GDP real growth of 10.9 percent and an implicit GDP deflator of 3.2 percent in the first half of 2006.

28. In Beijing, in 2002 and 2003, the minimum wage was 25.5 and 23.5 percent, respectively, of the average wage in those years. In 2004, in Shenzhen, the minimum wage was 18 percent of the average local wage (China's highest).

29. China Statistical Information Net, "Wages of Beijing Workers and Staff Increase Steadily; Differentials Across Industrial Branches Expand," www.hebei.gov.cn (accessed July 10, 2006).

rise in the capital's minimum wage in 2003 could not have had more than a minuscule effect on the total wage bill.³⁰

More generally, the past decade's data suggest that China's minimum wage program has had a modest effect on household consumption. During this period the minimum wage in Beijing more than doubled, from RMB270 per month in 1996 to RMB640 in 2006. In Shenzhen's special economic zone the minimum wage doubled from RMB398 to RMB810 over the same period.³¹ Presumably, minimum wages in other jurisdictions have had similar rates of increase. But over this period household consumption as a share of GDP has fallen significantly.³²

It is unlikely that the further 10 percent increase in Beijing's minimum wage in July 2006, to RMB640 per month, and the similar increases in other cities will significantly increase wage income. Thus, even allowing for the likely higher marginal propensity to consume of minimum wage workers, the expected effect of China's minimum wage program on household consumption expenditures is likely to be small.

In summary, the cuts in taxes on rural and urban incomes instituted by the central government beginning in 2004 and the increases in minimum wage levels introduced by provincial and local governments have had and are likely to continue to have a modest effect on household income, and thus they are unlikely to lead to significantly higher levels of household consumption expenditures. The cuts in taxes on urban and rural incomes are too small, and in rural areas they have been offset by increases in other taxes.

On the expenditure side, at the annual meeting of China's legislative body in the spring of 2006 the government announced increased outlays on a number of social programs. The centerpiece of this effort is Premier Wen Jiaobao's program to create a "new socialist countryside." The government has budgeted in 2006 for increased subsidies for grain producers, which will raise the incomes of some of China's poorest farmers; expanded coverage of the rural cooperative medical system, which was first rolled out in 2002; and announced that by 2007 it will eliminate educational fees for rural primary education. Other social initiatives were also unveiled.

30. In 2002 the share of Beijing's wage income earned by minimum wage workers can be estimated as 0.6 percent of total wage income (0.25×0.024). Assuming generously that the 6.5 percent increase in the minimum wage in 2003 had no effect on the number of minimum wage workers employed, the increase in the minimum wage would have raised total wage income by 0.04 percent.

31. See "Historical Minimum Wage Standards," available at www.labourlawyer.com (accessed July 3, 2006).

32. China's minimum wage system was established in 1993.

But the budgeted increase in expenditures on these programs is far from impressive. The increase in grain subsidies is only RMB1 billion. The expansion of the rural cooperative medical system is modest, seeking to expand coverage to only 40 percent of the rural population by 2010 and increasing the annual per capita government subsidies for this expansion only by an equivalent of \$2.50. Only the provision of free rural primary education, which is budgeted at RMB220 billion (\$27.5 billion) over five years, is significant. But the overall increase in rural spending in 2006 is budgeted at only 14 percent, not a significant increase from the pace of recent years and only equal to the growth of nominal GDP in the first half of 2006. And unlike most years, the budget message of the minister of finance at the National People's Congress did not provide a figure for total

China's transition toward more consumption-driven growth is likely to be substantially delayed.

budgeted outlays for social programs, so it is not clear whether the increase in social expenditures from the government budget in 2006 will be faster than the nominal growth of almost 18 percent in 2005 compared with 2004.

Finally, on the exchange rate, in July 2005 the Chinese authorities launched a reform program with several components: an initial revaluation by 2.1 percent vis-à-vis the US dollar; announcing that the currency could fluctuate by up to 0.3 percent per day and that its value increasingly would be determined by supply and demand in the market; and asserting that the renminbi would be managed with reference to a basket of currencies rather than simply being pegged to the dollar. These reforms could have led to a more flexible exchange rate and thus given the People's Bank of China greater flexibility in adjusting interest rates.

But to date these reforms have not resulted in much flexibility. The potential for the currency's value to move by as much as 0.3 percent per day has been entirely theoretical, and massive government intervention in the foreign exchange market continues to prevent the currency from appreciating significantly. In the five months from July through December 2005, the authorities purchased an average of \$19 billion per month, almost exactly the pace of intervention that occurred in the first six months of the year. In 2006 the average market intervention increased slightly to an average of \$20.4 billion in the first half (State Administration of Foreign Exchange 2006, 6). This directly contradicts the People's Bank of China announcement of the new exchange rate system, which emphasized the increasing role of the market and supply and demand in determining the

exchange rate. As a result, the cumulative appreciation of the renminbi vis-à-vis the dollar in the first year of the “new” exchange rate system was less than 2 percent. Finally, there is little evidence of pegging to a basket of currencies. In short, China’s exchange rate system remains a heavily managed peg to the dollar and does not provide the authorities with any significant increase in monetary policy independence.

One additional important development—a sharp decline in borrowing by consumers since 2003—suggests that the transition to a more consumption-driven growth path will be difficult, at least in the short run. The inability of consumers to borrow against future income historically has been an important factor contributing to a high rate of household saving in China. This began to change in the late 1990s, when banks started lending to consumers for the first time. Net annual lending to households grew rapidly from only RMB30 billion in 1998 to RMB510 billion in 2003. By the end of 2003, loans to households accounted for 10 percent of all bank loans outstanding. Subsequently, however, lending to households fell sharply to RMB435 billion in 2004 and then RMB200 billion in 2005, below the level of 2000.³³ Banks appear more than willing to lend to households, so the slowdown in borrowing appears to reflect declining consumer confidence or perhaps a wait and see attitude on mortgage borrowing in many cities where sharp housing price increases of recent years have begun to moderate and in some cases reverse. In either case the implications for consumption growth are adverse since home purchases typically lead to increased expenditures on furnishings, appliances, and so forth, all of which are included in consumption expenditure.

CONCLUSION

The evidence to date suggests that the transition to more consumption-driven growth is off to a slow start. In the first half of 2006, it appears that investment grew more rapidly than GDP;³⁴

33. These data are for what Chinese sources call “household consumption loans,” which include loans for mortgages, car purchases, tuition, and general consumer credit. They do not include what are called “household economic loans,” which are working capital loans extended to Chinese peasants for the purchase of seeds, fuel, fertilizer, and other agricultural inputs.

34. China’s high-frequency data on investment are for “fixed asset investment.” Most observers believe that this measure includes the value of land sales, as well as the value of mergers and acquisitions transactions. Since these transactions reflect changes of ownership rather than additions to productive capacity, they should not be included in fixed investment. In 2005 capital formation, as reflected in the GDP expenditure accounts, grew by roughly three-quarters of the pace of growth of fixed asset investment. Assuming the same proportional relationship applies in 2006, the reported 30 percent growth of fixed asset investment in the first half would translate into an expansion of fixed capital formation by about 23 percent in nominal terms, well in excess of the reported pace of expansion of nominal GDP of 14.3 percent.

China’s trade surplus expanded by more than half, meaning that net exports as a share of GDP are still rising rapidly. Thus China’s external surplus continues to balloon and, short of a US recession, seems likely to expand further in 2007. Government consumption expenditures appear to be growing roughly in line with nominal GDP growth. Since GDP is the sum of capital investment, consumption (household and government), and net exports, it can only mean that household consumption is growing more slowly than GDP. Thus household consumption as a share of GDP almost certainly continued to decline in the first half of 2006. Similarly, the government has acknowledged that the elasticity of energy consumption with respect to GDP continued to rise in the first half of 2006, extending the trend of the previous five years.³⁵

The reasons government policy has thus far failed to put China onto a new growth path are clear. First, the tax burden on rural residents has not declined significantly. Second, income taxes paid by urban residents are too modest for cuts to have a perceptible effect on consumption. And despite much lip service to increasing the provision of social services financed through the budget, there is little evidence that a fundamental shift in government spending priorities is under way. Thus the precautionary demand for savings on the part of China’s households persists.

Similarly, there is little evidence of a more flexible exchange rate and increased independence of monetary policy that would allow higher domestic interest rates. Government agencies issue repeated directives calling for reduced investment in sectors with excess capacity. But even after two modest increases in interest rates on loans in 2006, the rates paid by corporate borrowers remain very low in real terms.³⁶ In the first half of 2006 the increase in bank credit outstanding, almost entirely to corporate customers, was 50 percent greater than in the first half of 2005 (People’s Bank of China 2006b). Equally important, the real interest rate on corporate bank deposits remains negative, almost insuring that state-owned companies reinvest all of their retained earnings, even when expected returns are low or even moderately negative. Finally, consumer confidence seems to be waning, with a marked slowdown in borrowing starting in 2004. All of these factors suggest that China’s transition toward more consumption-driven growth is likely to be substantially delayed.

That comparison strongly suggests that properly measured, the investment share of GDP continued to rise in the first half of 2006.

35. “A Failed Mid-Term Exam,” editorial, *China Daily*, August 3, 2006, 4.

36. Effective August 15, 2006, the benchmark rate on a one-year loan was raised 27 basis points to 6.12 percent. The corporate goods price index in August 2006 rose 2.9 percent over a year ago, making the real lending rate faced by corporate borrowers only 3.22 percent, an extremely low rate in an economy growing at over 10 percent.

REFERENCES

- China Economic Research and Advisory Programme. 2005. China and the Global Economy: Medium-Term Issues and Options (December). On file with author.
- Chou, Shin-Yi, Jin-Tan Liu, and James K. Hammitt. 2002. National Health Insurance and Precautionary Saving: Evidence from Taiwan. *Journal of Public Economics* 87: 1873–94.
- Goodfriend, Marvin, and Eswar Prasad. 2006. *A Framework for Independent Monetary Policy in China*. IMF Working Paper WP/06/11 (May). Available at www.imf.org (accessed October 6, 2006).
- IMF (International Monetary Fund). 2006. *Regional Economic Outlook: Asia and Pacific* (May). Washington. Available at www.imf.org (accessed August 16, 2006).
- Kuijs, Louis. 2006. *How Will China's Savings-Investment Balance Evolve?* World Bank Research Paper 5 (May). Beijing: World Bank China Office.
- Kuijs, Louis, William Mako, and Chunlin Zhang. 2005. *SOE Dividends: How Much and to Whom?* World Bank Policy Note (October 17). Washington: World Bank. Available at www.worldbank.org (accessed August 9, 2006).
- Kuijs, Louis, and Tao Wang. 2005. *China's Pattern of Growth: Moving to Sustainability and Reducing Inequality*. World Bank Policy Research Working Paper 3767 (November). Washington: World Bank.
- Ma Guonan. 2006. Who Foots China's Bank Restructuring Bill? In *The Turning Point in China's Economic Development*, eds. Ross Garnaut and Ligang Song. Canberra: Asia Pacific Press at the Australian National University.
- Ministry of Finance, Ministry of Agriculture, and State Tax Bureau. 2004. Notice Concerning Issues in Lowering the Agricultural Tax Rate and Carrying Out the Reform of Eliminating the Agricultural Tax in Trial Points, June 30. Beijing. Available at www.mof.gov.cn (accessed July 21, 2006).
- Ministry of Finance. 2005. *Progress in the Work of Reforming Rural Taxes and Fees in 2004 and the Direction for Work in 2005* (March 2). Beijing. Available at www.mof.gov.cn (accessed July 21, 2006).
- Ministry of Labor and Social Security. 2003. *Regulations on the Minimum Wage* (December 30). Beijing. Available at www.trs.molss.gov.cn (accessed June 29, 2006).
- National Bureau of Statistics of China. 2005. *China Statistical Yearbook 2005*. Beijing: China Statistics Press.
- National Bureau of Statistics of China. 2006a. *China Statistical Abstract 2006*. Beijing: China Statistics Press.
- National Bureau of Statistics of China. 2006b. *China Statistical Yearbook 2006*. Beijing: China Statistics Press.
- National Development and Reform Commission. 2006. Report on the Implementation of the 2005 Plan for National Economic and Social Development and on the 2006 Draft Plan for National Economic and Social Development (March 5). Beijing. Available at www.npc.gov.cn.
- OECD (Organization for Economic Cooperation and Development). 2005. *China*. OECD Economic Surveys, volume 2005/13 (September). Paris.
- People's Bank of China. 2006a. *Quarterly Statistical Bulletin* no. 41. Beijing.
- People's Bank of China. 2006b. *Overall Balance in Financial Circulation in the First Half of 2006* (July 14). Beijing. Available at www.pbc.gov.cn (accessed July 14, 2006).
- People's Bank of China, Monetary Policy Analysis Small Group. 2005. *Report on the Implementation of Monetary Policy 2005Q2* (August 4). Beijing. Available at www.pbc.gov.cn.
- People's Bank of China, Monetary Policy Analysis Small Group. 2006. *Report on the Implementation of Monetary Policy 2006Q2*. Beijing. Available at www.pbc.gov.cn (accessed August 9, 2006).
- State Administration of Foreign Exchange, International Income and Expenditure Analysis Small Group. 2006. *Report on China's International Balance of Payments in the First Half of 2006* (October 6). Available at www.safe.gov.cn (accessed October 6, 2006).
- State Tax Bureau. 2005a. *The Adjustment of the Individual Income Tax Will Bring RMB28 Billion in Benefit to Tax Payers* (November 17). Beijing. Available at www.mof.gov.cn (accessed July 21, 2006).
- State Tax Bureau. 2005b. *The Reduction in and Exemption from the Agricultural Tax Is Estimated to Reduce the Farmers' Burden by RMB22 Billion* (December 23). Beijing. Available at www.mof.gov.cn (accessed July 20, 2006).
- Wolf, Martin. 2005. Why Is China Growing So Slowly? *Foreign Policy* (January–February). Available at www.foreignpolicy.com (accessed August 4, 2005).

The views expressed in this publication are those of the author. This publication is part of the overall program of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.